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ASSOCIATION OF AMERICAN RAILROADS

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BY HAND DELIVERY

April 20, 2005

Honorable Vernon A. Williams
Secretary
Surface Transportation Board
1925 K Street, N.W.
Washington, D.C. 20423

Re: Ex Parte No. 657, Rail Rate Challenges Under the Stand-Alone Cost Methodology

Dear Secretary Williams:

On April 18, 2005, the Association of American Railroads ("AAR") indicated that it would file written testimony in this proceeding, and requested an allotment of up to five minutes of speakers' time to present oral testimony at the upcoming April 26, 2005, hearing.

The AAR believes that its written testimony, filed today, fully expresses its position on the issues before the Board in this proceeding. Accordingly, the AAR hereby withdraws its request to present oral testimony at the April 26th hearing.

An original and ten copies of this letter are submitted for the Board's purposes.

Respectfully submitted,

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BEFORE THE
SURFACE TRANSPORTATION BOARD
WASHINGTON, D.C.

STB EX PARTE NO. 657

RAIL RATE CHALLENGES UNDER THE STAND-ALONE COST METHODOLOGY

WRITTEN TESTIMONY OF THE ASSOCATION OF AMERICAN RAILROADS

The Association of American Railroads ("AAR") submits this testimony on behalf of its member railroads in response to the Surface Transportation Board's ("Board") Notice of Public Hearing served February 16, 2005 in the above proceeding.

The AAR's testimony will offer the general context of regulatory policies and economic principles within which the Board should consider SAC related issues. AAR member railroads, in separate comments, will address more specific SAC matters based upon their respective concerns and experiences in SAC cases.

A fundamental regulatory tenet that the Board must take into account in matters involving maximum rate regulation, including SAC methodology, is the statutory requirement that the railroads must be afforded the opportunity to earn adequate revenues. The Rail Transportation Policy specifically provides that the railroads be allowed to earn adequate revenues (49 U.S.C. § 10101(3); and the Board is mandated to provide rail carriers with the opportunity to attain revenue adequacy (as defined at 49 U.S.C. § 10704(a)(2)). Moreover, the Board is to take that policy goal into account in its exercise of jurisdiction over the maximum level of rail rates (49 U.S.C. § 10701(d)(2)).

The dire financial and competitive conditions confronting the rail industry before 1980 – the catalyst giving rise to these statutory requirements -- are well known. However, even though the railroads have made substantial progress in improving their financial and competitive position since then, none still is earning its cost of capital. Equally significant is that the railroads face many of the same basic economic conditions that they faced in 1980 as well as new challenges.

The railroads have extremely high fixed and common costs that must be covered regardless of traffic levels (e.g., track structure and related facilities). In fact, railroads have significantly higher asset needs for each dollar of revenue produced than other industries. Based on Fortune 500 data, the figure for railroads ($2.82) is well over twice the average for industrial firms ($1.18). For the most recent five year period for which data are available (1999-2003), freight railroads spent an average of 17.0 percent of their revenues on capital investments compared to an average of 3.4 percent for all manufacturing industries. Over the same period, industry capital expenditures have ranged from approximately five to seven billion dollars annually. When maintenance expenses on rail rights of way and equipment are added to the capital expenditures, the extraordinary level of costs necessary for the railroads to operate efficiently and effectively equals, on average, approximately 45 percent of operating revenues.

Moreover, continued investments in rail infrastructure must be made to ensure sufficient future rail capacity and capability. According to recent U.S. DOT forecasts, rail tonnage will rise 55 percent by 2020, presenting increasingly serious capacity issues. Rail customers will continue to insist on service improvements that require accompanying investments. And with highways becoming ever-more congested and costly (a point well known to motor carriers, who are rapidly expanding their use of rail intermodal service to avoid the all-highway option) and demands to conserve fuel, reduce emissions, and improve safety on the rise, pressure on railroads to provide relief will only increase.

On the demand side, rail customers differ widely in the contribution to fixed costs that they can be asked to make without shifting to other transportation options. Some rail traffic can easily shift to other transportation modes while other rail traffic with fewer competitive alternatives is less easily diverted. This latter traffic can be charged higher mark ups to reflect the associated higher reliance on rail services.

Given the cost and demand structure of the rail industry, the railroads must be able to differentially price their services if they are to have the hope of attaining revenue adequacy. The railroads must price their services on the basis of demand with those shippers having the strongest demand paying higher mark ups than shippers with lower demands. As a result, railroads can cover their variable costs and spread their fixed costs across the greatest number of customers with each sharing appropriately in proportion to its relative need for rail service. This approach is the fairest, most efficient, and most pro-competitive pricing system consistent with supporting the continued viability of the railroads. All shippers, including those which are paying a higher mark up, benefit from differential pricing because it maximizes the number of shippers using the rail network and, therefore, the number of shippers which contribute to the railroads' large fixed and common cost base.

In its decision articulating the economic principles it adopted for dealing with rate reasonableness complaints, the Interstate Commerce Commission ("ICC") recognized -- as Congress had also earlier observed -- that regulation must allow the railroads to differentially price their services to allow them the opportunity to become revenue adequate. (Coal Rate Guidelines -- Nationwide, 1 I.C.C. 2d 520, 526-8 (1985) ("Coal Rate Guidelines"); See also, H.R. Rep. No. 96-1035, 96th Cong., 2d Sess. 39-40, 121-122 (1980)). Accordingly, the ICC's Coal Rate Guidelines were designed to allow differential pricing and the opportunity to earn adequate revenues while also protecting against any abusive pricing practices.

In Coal Rate Guidelines, the ICC adopted Constrained Market Pricing ("CMP") for assessing differential pricing in a regulatory context. It had concluded that implementation of a "Ramsey pricing" methodology would permit efficient railroads engaged in differential pricing to recover all of their costs and thus have the opportunity to attain revenue adequacy. However, the ICC did not deem it practical to impose Ramsey pricing as a regulatory requirement for general application, and instead adopted CMP as a surrogate to approximate Ramsey prices (Id. at 526-8).

Whether Ramsey pricing or its regulatory surrogate CMP is to be used, the goal is the same. Revenue inadequate railroads are encouraged to set their rates in accordance with market demand; and as long as those shippers with fewer competitive options do not bear the burden of unreasonable management inefficiencies or cross subsidizing other traffic, a railroad is free to adjust its rates to the market's requirements. If a shipper complains that a rate is unreasonable for a particular service, the SAC test is the primary CMP constraint used to determine if the rates at issue are unreasonably high. As essentially a measure of whether a railroad is properly differentially pricing its services, the SAC test must be applied in a manner which is consistent with and does not undermine overarching statutory revenue adequacy goals.

The regulatory policies and economic principles of the Staggers Act affording railroads the opportunity to earn adequate revenues have been an unqualified success both for railroads and their customers. Rail traffic volume rose nearly 70 percent since 1980 and rail productivity rose 178 percent – compared to 10 percent in the comparable pre-Staggers Act period. Nearly all these productivity gains have been passed through to rail customers in the form of lower rates, saving them billions of dollars per year. The railroads are clearly in a better position financially than in 1980. Yet, the railroads still are not earning their cost of capital and are still facing basic economic conditions that compel differential pricing: a huge and growing need for capital infusions, which drive high fixed costs, coupled with wide variations in the ability of rail customers to contribute to those fixed costs.

As the Board considers SAC related suggestions and concerns raised by AAR member roads and other parties, the AAR urges that the Board do so in the context of those legislative and regulatory policies and economic principles supporting railroad revenue adequacy and differential pricing. Indeed, in every aspect of applying SAC theory or methodology, the Board must take into account the statutory mandate that the

Board afford railroads the opportunity to earn adequate revenues. If the SAC test is to serve the purpose of reflecting sound regulatory economic principles – whether based on Ramsey pricing or CMP -- the SAC test must be applied in accordance with the fundamental regulatory policies of the Staggers Act.

Respectfully submitted,

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